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Supreme Court of the United States

October Term, 1927

No. 554 16

ELIZABETH C. TAFT, *Petitioner,*

vs.

FRANK K. BOWERS, Collector of Internal Revenue for the Second District of the State of New York,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

BRIEF FOR PETITIONER

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BRIEF FOR PETITIONER.

Statement.

The opinion of the United States District Court for the Southern District of New York in the above case is reported in 15 Fed. (2) 890. The opinions of the Judges of the Circuit Court of Appeals for the Second Circuit are reported in 20 Fed. (2) 561.

This cause comes before this Court on a writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit granted by this Court on November 21, 1927, to review a decree of the United States Circuit Court of Appeals, Second Circuit, filed on July 13, 1927 (R. 24). The petitioner relies upon the provisions of Section 240 of the Judicial Code as authority for the jurisdiction of this Court.

The facts involved are not complicated. Elizabeth C. Taft, the petitioner, received from her father by gift one hundred fifty (150) shares of the common stock of The Nash Motors Company, a corporation duly organized and existing under the laws of the State of Maryland. One hundred (100) of these were received by her on or about December 12, 1921, and fifty (50) shares were received by her on or about March 18, 1922 (R. 3). Her father had acquired the said shares as a bonus with a purchase of other stock of The Nash Motors Company at about the time of its incorporation in 1916, and he could not establish that the stock had cost him any definite sum (R. 4). In other words, for the purposes of this action the basis of cost in the hands of the donor was nothing. The said shares were transferred on the books of the corporation to the petitioner's name, so that on December 26, 1922, she was the owner of record of one hundred fifty (150) shares of the said common stock of The Nash Motors Company (R. 3).

On or about February 1, 1923, The Nash Motors Company declared a stock dividend of four shares of common stock and three shares of preferred stock on each share of common stock, to shareholders of record on December 26, 1922. Accordingly the petitioner received during 1923, as a stock dividend, six hundred (600) shares of the common stock and four hundred fifty (450) shares of the preferred stock of The Nash Motors Company. She thus became the owner of record of seven hundred fifty (750) shares of the common stock and four hundred fifty (450) shares of the preferred stock of the company (R. 3).

During the year 1923 and after the receipt of the stock dividend the petitioner sold two hundred (200) shares of the common stock and one hundred thirty (130) shares

of the preferred stock of the said company for $34,345.30 (R. 3 and 4).

On or about March 15, 1924, she made her individual income tax return to the United States Government for the calendar year 1923 showing a net income of $40,972.75 (R. 4) and included therein the total amount of the receipts of such sale, to wit, $34,345.30, as income on her return, in accordance with the requirements of Section 202 (a) (2) of the Revenue Act of 1921 (42 Stat. at Large, Chapter 136, pp. 227-321) then in force. On or before June 15 of the same year the petitioner paid to the respondent but under protest, the entire amount of tax calculated to be payable on the basis of the return so filed, to wit, $4,320.50 (R. 4).

The total fair market value of the one hundred fifty (150) shares of common stock at the time it was given to the petitioner was $42,350 (R. 4). The proportion of this amount allocated according to the rulings of the United States Treasury Department to the stock originally issued and to that issued as a dividend gave to the two hundred (200) shares of common stock and the one hundred thirty (130) shares of preferred stock sold by the petitioner in 1923 a value of $11,708.80 as of the time she acquired it (R. 4). In other words, the increment attributable to the shares sold which had accrued prior to acquisition by the petitioner was $11,708.80, and she claims that the income tax can not be based upon that increment, because it accrued before she owned the stock. She was, however, required to state it in her return and has paid in respect of it a tax of $2,040.09, which she now seeks to recover (R. 5).

On or about June 15, 1924, and within the time prescribed by law, the petitioner took an appeal to the Commissioner of Internal Revenue by filing with the respon-

dent a claim for a refund of the tax so paid on the said $11,708.80 (R. 5). After six months—the Commissioner having taken no action on the claim in that period—suit was brought in the United States District Court for the Southern District of New York for the recovery of the tax on the ground that the tax on the $11,708.80 of increment which accrued prior to the ownership of the stock by the petitioner was illegally and erroneously collected (R. 3-6).

The Statutes.

Section 202 (a) (2) of the Revenue Act of 1921 [42 Stat. at Large, 227-321] provides:

> "(a) That the basis for ascertaining the gain derived or loss sustained from a sale or other disposition of property, real, personal, or mixed, acquired after February 28, 1913, shall be the cost of such property; except that—"
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> • • • • • • • • • •
>
> "(2) In the case of such property, acquired by gift after December 31, 1920, the basis shall be the same as that which it would have in the hands of the donor or the last preceding owner by whom it was not acquired by gift. If the facts necessary to determine such basis are unknown to the donee, the Commissioner shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Commissioner finds it impossible to obtain such facts, the basis shall be the value of such property as found by the Commissioner as of the date or approximate date at which, according to the best information the Commissioner is able to obtain, such property was acquired by such donor or last preceding owner."

Section 213 (a) of the Revenue Act of 1921 provides:

"That for the purposes of this title (except as otherwise provided in Section 233) the term 'gross income' (a) includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including in the case of the President of the United States, the judges of the Supreme and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items (except as provided in subdivision (e) of section 201) shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period; but

"(b) Does not include the following items, which shall be exempt from taxation under this title:

* * * * * * * * *

"(3) The value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included in gross income)."

ARGUMENT.

POINT I.

The Circuit Court of Appeals erred in holding that the increment of $11,708.80 which accrued prior to ownership by the petitioner was "income" taxable to the petitioner, or, indeed, that it was income at all.

This case involves a basic and important principle of Income Tax Law. Fundamentally it seems to us that it must be determined whether the power granted to Congress by the Sixteenth Amendment to the Constitution to "lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States," empowers the Congress to ignore the identity of separate taxpayers, set an arbitrary basis for determining gain or loss on the sale of capital assets and tax to the last successor in title as income any increase in value between the basis so fixed and the amount realized, although such increase, or some of it, may have occurred long prior to the time when the present taxpayer owned, possessed or had any right of disposition and control over the property.

At the outset let it be said that this case does not involve the taxation of any gain derived upon the increase in value after acquisition of the property by the petitioner, and hence the case of *Rice* v. *Eisner* (16 Fed. 2d, 358; certiorari denied) can have no bearing. The petitioner returned the gain so made as income and paid the tax upon it without asking for any refund (R. 5), assuming that the question of the taxation of that profit had long since been settled in *Merchants Loan & Trust Co.*

v. *Smietanka,* 255 U. S. 509, and companion cases. We are therefore confronted with the single question as to whether the $11,708.80 representing increment in value which accrued prior to acquisition by the petitioner was "income" to her in 1923 when converted into cash by sale.

"Income" has been defined to mean "the gain derived from capital, labor, or from both combined, provided it is understood to include profit gained through a sale or conversion of capital assets" (*Eisner* v. *Macomber,* 252 U. S. 189, 207). In order to apply this definition, we must determine first what is profit or gain to the taxpayer. The value of the gift itself is not profit or gain, but is capital in the hands of the donee (*Edwards* v. *Cuba R. R. Co.,* 268 U. S. 628; *U. S.* v. *Oregon-Washington R. & Nav. Co.,* 251 Fed. 211 C. C. A.). Indeed the statute itself specifically provides that a gift is not to be included in the gross income of the donee. See Section 213 (b) (3) above. Moreover, as the gifts were received in 1921 and 1922, the question of taxing them in 1923, the year here under review, is not directly involved.

Prior to the year 1921 there was no specific provision in the various Revenue Acts which fixed the basis for determining gain or loss on the sale of property acquired by gift, devise or bequest. The statute provided that the basis to determine gain on the sale of assets was cost or March 1, 1913, value (Rev. Act 1918, 40 Stat. at Large, Chapter 18, p. 1060; Rev. Act. 1916, 39 Stat. at Large, Chapter 463, page 758).

The uniform rule of the Treasury Department under these prior statutes was that the basis to be used for determining gain upon the sale of an asset acquired by gift, devise or bequest was the value of such property when acquired. (U. S. Treasury Department Regulations 33

Rev. Art. 4; U. S. Treasury Department Regulations 45, Art. 1562); and indeed the regulations still provide, with respect to gifts made prior to December 31, 1920, that the basis is the value when acquired. (U. S. Treasury Department Regulations 69, Art. 1594.) In other words, until the Revenue Act of 1921 became effective the Department laid down the rule that gain on the sale of property acquired by gift could be computed only by taking into consideration the value of the gift, when it was acquired. This was an express recognition by the Treasury Department that a gift is a capital transaction, as pointed out in *Edwards* v. *Cuba R. R. Co.* and *U. S.* v. *Oregon-Washington R. & Nav. Co., supra,* and that the donee can have "gain" only to the extent that the proceeds in his hands exceed the value of his capital at the time of acquisition. These rulings are entitled to great weight (*U. S.* v. *Hill,* 120 U. S. 169, 188). If they are sound—and we submit that they are—then no basis other than value at acquisition by the donee should be adopted to determine what is "gain" upon the sale of the property and one that adopts any other method is contrary to all of the established and settled conceptions of computing gain on capital assets.

In *Goodrich* v. *Edwards,* 255 U. S. 527, this Court held that the Income Tax Act of 1916 taxed "gains" only, and that a taxpayer could have no gain until the proceeds of the sale exceeded his cost, even though the proceeds may have exceeded the March 1, 1913, value. In *Lynch* v. *Turrish,* 247 U. S. 221, this Court passed upon the question as to whether an increase in the value of capital assets which has accrued prior to March 1, 1913, was income to a taxpayer when realized after that date at a very great increase over the cost price. In passing upon the question this Court said that there was "no increase sub-

ject to tax," allowing the taxpayer to recover his capital investment on March 1, 1913. So also in *Doyle* v. *Mitchell Bros.*, 247 U. S. 179, this Court refused to tax to a corporation as income an increase which had accrued prior to the passage of the Corporation Franchise Tax Law of 1909, but realized by sale by the corporation after the Act was effective, saying:

> "In order to determine whether there has been gain or loss, and the amount of gain if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration."

We see no reason for distinguishing between a case where the increase occurred prior to the passage of the taxing statute and a case where the increase occurred prior to ownership by the present taxpayer. If a taxpayer in the former case is entitled to recover his capital investment before he can have any gain *a fortiori*, a taxpayer in the latter case should be entitled to recover his capital investment which he acquired at the date of the gift. We submit that the above decisions lay down definitely the principle that a taxpayer is entitled to recover *his* cost or capital investment before he can have gain or income.

If then a taxpayer's capital investment at the time of acquisition is not "income", as it is is usually understood, a statute which seeks to make it such is invalid. In *Eisner* v. *Macomber*, 252 U. S. 189, this Court had before it the question whether stock dividends were income and whether a statute which declared them to be such was valid. The Court held that the statute was invalid, and laid down very definitely the principle that Congress has no power under the Sixteenth Amendment to tax some-

thing as income which is in fact and in substance not income. Thus it was settled for all time that Congress can not arbitrarily call something income and tax it as such if it is not in fact income. So we contend that Congress cannot by arbitrarily fixing a basis for determining gain include in that gain something which in fact and in substance is the capital of the taxpayer. Such a statute is, we submit, unconstitutional and within the inhibition laid down by this Court in *Eisner* v. *Macomber, supra.*

To turn to the specific facts of this case we claim that the petitioner was entitled, in estimating the gain on the sale of her stock, to treat $11,708.80 of its value when she acquired it as a capital investment and not as income on which a tax was payable. Her income in the constitutional sense was the difference between this $11,708.80 and the proceeds of the sale; and Section 202 (a) (2) of the statute, which required her to include this $11,708.80 as income, was unconstitutional.

POINT II.

The Circuit Court of Appeals erred in finding that the provisions of Section 202 (a) (2) of the Revenue Act of 1921 were not capricious and arbitrary and contrary to the Fifth Amendment to the United States Constitution.

That the results of the application of the statute here under consideration are arbitrary and capricious is plain. Let us illustrate: A bought stock for $10. He makes a bona fide gift of it to B after December 21, 1920, when it is worth $100, and B sells the stock for $200. The statute provides that B has a gain of $190. Thus B is given no

benefit whatsoever of the capital which he received at the commencement of his period of ownership and the indirect effect of the statute is that he is taxed on a part of the value of the gift, which the statute provides in another Section (Section 213 (b) (3)) shall not be taxed as income. So far as B is concerned, he has an actual economic gain of $200, but it has long ago been settled that an economic gain is not necessarily a taxable gain in the constitutional sense. *Gould* v. *Gould*, 245 U. S. 151; *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330; *United States* v. *Oregon-Washington R. & Nav. Co., supra.*

In the instant case the result of the statute is that the petitioner is by indirection taxed on the whole value of her gift.

Let us reverse the above example: A bought stock for $200. He gives it to B after December 31, 1920, when it is worth $100, and B, after a year, sells for $10. The statute provides that B has a loss of $190. This is absurd and unreal, because B never had anything worth $190 to lose. The capital asset in his hands never exceeded a value of $100, and that is the most that he could in fact possibly lose, yet the statute allows him a loss of $190. It was just this sort of unreality and disregard of actual facts that this court refused to sanction in *Goodrich* v. *Edwards, supra*, and in the later case of *U. S.* v. *Flannery*, 268 U. S. 98. In the first of these this Court held that a taxpayer could not have a gain unless his sale price exceeded his cost, irrespective of the 1913 value. In the latter case, this Court held that a taxpayer could not have a loss unless his sale price was less than cost, irrespective of March 1, 1913, value. Surely a statute which provides that a taxpayer shall be taxed on an increase which occurred before his ownership, and on the other hand that he shall be entitled to a loss far in excess of any value he ever owned in an asset, is unreal, contrary to fact and

absurd. Its results cannot help but be capricious and arbitrary. Its result was arbitrary in this case. It taxed the petitioner as if she had no capital investment at any time. Unless, then, we are to come to the conclusion that Congress can, in its power to levy income taxes, set any arbitrary basis for determining profit or loss to the taxpayer, with total disregard of the existing and proven facts and to the fixed conceptions of gain and loss as they have become to be known in ordinary custom through long years of business experience, we do not see how this statute can stand.

This Court has said that Congress must not use its taxing power in such an arbitrary and capricious manner as to invade the rights of citizens under the Fifth Amendment to the Constitution (*Frew* v. *Bowers,* 12 Fed. (2) 625; *Coolidge* v. *Nichols,* 274 U. S. 531; *Blodgett* v. *Holden,* 275 U. S. 142). We submit that this is such an instance.

POINT III.

The Circuit Court of Appeals erred in holding that Section 202 (a) (2) of the Revenue Act of 1921 was a legitimate and necessary exercise of the power ancillary to the power to levy taxes.

The Circuit Court of Appeals was evidently influenced in its opinion by the fact that Congress was seeking to supply what was regarded as a weakness in the statute, as evidenced by expressions like the following:

> "The obvious purpose of Section 202 (a) (2) was to prevent the loss of income represented within the profit to the donor during the period he held the property before he made the gift" (R. 17).

* * * * * * *

> "The method of the statute which regards the corpus of the gift, irrespective of its value, as a thing which is transferred is essential to the entire taxing scheme" (R. 18).
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> • • • • • • •
>
> "That the statute is reasonably ancillary to a valid constitutional purpose seems to me as plain, as in Rice v. Eisner, 16 Fed. (2) 358 (C. C. A. 2); that the practice, if permissible, will become a common contrivance to frustrate that purpose, I have no doubt whatever" (R. 22).

Admittedly the provisions of the above Section were adopted to remedy what was regarded as a weakness in the statute, but we submit that however urgent the need for supplying the omission, the need does not justify an illegal and unconstitutional means. The Sixteenth Amendment authorized Congress to lay and collect taxes on "incomes", and the various Revenue Acts attempt only to levy a tax on "income". To attempt to remedy the situation by adopting a basis for determining gain which is inherently fallacious does not answer the argument that the amount so included is not income (*Eisner* v. *Macomber, supra*). The Circuit Court of Appeals in justifying the means seems to have overlooked this fundamental principle.

Nor is it sufficient to justify the means that the omission might have been closed by other methods of taxation, as, for example, an excise tax on the gift, as suggested by the learned Judges below. It must be remembered that we are here dealing with "income" tax, and that the Sixteenth Amendment sanctions a tax on income only. That another method of supplying the omissions in the statute might have been valid, cannot be relied on to sustain an unconstitutional attempt to levy what was obviously intended to be an income and not an excise tax. Nor is the means justified by saying that the donee

took the property impressed with a tax liability. First of all no income tax liability with respect to the property attached to donor at any time prior to or at the time of the gift (*People ex rel. Wilson* v. *Wendell*, 196 N. Y. App. Div. 596) so there was no liability to pass on. Secondly the argument has been effectively answered by the decision of the court in *Miles* v. *Graham*, 268 U. S. 501. There it was held that a federal judge could not be taxed on his salary contrary to the provisions of the Constitution even though he took the judgeship after the passage of the Revenue Acts and with the knowledge that the Act attempted to tax his salary.

Furthermore in seeking to uphold the Statute the Circuit Court of Appeals has overlooked another well established principle with respect to the Income Tax Law. That principle is, that from the inception of our Federal Income Tax Laws a clear and distinct cleavage has been made between different taxpayers. Such has become settled practice, both in the wording of the laws and in the decisions that have been made under them. The tax is levied on individuals, fiduciaries and corporations (Secs. 210, 219, 230). For instance, the statute draws a very clear distinction between a decedent and his executors as taxpayers and sets them up as separate taxpayers. (See Sections 210 and 219 of the Statute). So, too, the statute is very clear in separating a corporation and its stockholders. (See Sections 201 and 230.) A very recent case on this subject (*Bankers' Trust Co.* v. *Bower*, 23 Fed. (2nd) 941) goes into great detail in drawing this distinction between an executor and a deceased for tax purposes. In other cases it has been held that a legatee is not liable for increase that accrued in the hands of an executor. (*Brewster* v. *Gage*, U. S. Dist. Court, Western Dist. of N. Y., Dec. 27, 1927, unreported; *Ap-*

peal of Mathiessen, 2 B. T. A. 921.) Indeed, this separation into distinct classes of different taxpayers underlies the whole structure of the decisions expounding the theory of realized gain on the sale of capital assets. If any other theory is to be adopted, it can know no bounds, and the person acquiring property can never tell what liability he assumes in the way of income tax if any basis entirely foreign to him can be arbitrarily adopted for determining his gain. It is this fact that no doubt underlies the attempt in the statute and the trend in the decisions always to draw a distinct line between separate taxpayers. If a decedent and his executor or a deceased and his legatees must be dealt with separately, surely there is no justification for confusing the identity of a donor and a donee and treating them as one. Indeed, the legal status of an executor is much more closely identified with the decedent than that of the donor with the donee. So we submit that in determining this gain the court must be concerned "with whose income it is" (R. 21) in the words of one of the Justices of the Circuit Court of Appeals, and that any decision which ignores this principle is not sound.

Respectfully submitted,

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